



The Dodd-Frank Act: Creative Destruction, Destroyed

By Peter J. Wallison

The dominant theme of the 2,300-page Dodd-Frank Wall Street Reform and Consumer Protection Act is fear of instability and change, which the act suppresses by subjecting the largest financial firms to banklike regulation. The competitiveness, innovativeness, and risk taking that have always characterized U.S. financial firms will, under this new structure, inevitably be subordinated to supervisory judgments about what these firms can safely be allowed to do. But the worst element of this system is that the extraordinary power given to regulators—and particularly the Federal Reserve—is likely to change the nature of the U.S. financial system. Where financial firms once focused on beating their competitors, they will now focus on currying favor with their regulator, which will have the power to control their every move. What may ultimately emerge is a partnership between the largest financial firms and the Federal Reserve—a partnership in which the Fed protects them from failure and excessive competition and they in turn curb their competitive instincts to carry out the government’s policies and directions. In addition, with the creation of the Consumer Financial Protection Bureau, the act abandons a fundamental principle of the U.S. Constitution, in which Congress retains the power to control the agencies of the executive branch. These wholesale changes in traditional relationships are hard to explain except as the triumph of a fundamentally different view—a corporatist political model more characteristic of Europe—of the government’s role in the U.S. economy.

My mother always told me that what’s done is done, and there’s no sense worrying about decisions that cannot be changed. Still, it is useful to put down some markers about the recently adopted Dodd-Frank Act (DFA), which looks to be the most troubling—maybe even destructive—single piece of financial legislation ever adopted. The reason markers are useful is that they alert observers—especially those in Congress with the power to do something about it—to the problems they should be looking for in the future. And they might even alert regulators—charged with implementing the legislation—to the dangers of taking full advantage of what Congress has offered them. Given these objectives, this *Outlook* will discuss the most serious policy problems implicit in the DFA.

Regulation to Prevent “Instability”

This is probably the heart of the act, which was sold on the claim that it would prevent the recurrence of

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a financial crisis. As might be expected, one can find in the solution the germ of the putative cause. Some see this cause as the free-market system itself;

Key points in this *Outlook*:

- The Dodd-Frank Act gives the Federal Reserve, under light supervision by a council of regulators, unprecedented control over the largest firms in the U.S. financial system.
- The result may be a public-private partnership, in which the Fed protects the largest firms from excessive competition and failure and they in turn follow the government’s directions.
- In the interest of protecting consumers, the act sacrifices the basic protections built into the U.S. Constitution, creating an agency—the Consumer Financial Protection Bureau—that is answerable to no one.
- Ultimately, the act’s effort to suppress risk taking will result in a decline in U.S. competitiveness, innovation, and economic growth.

others see it as a failure of regulators—with powers already in place—who did not take the necessary actions to prevent the crisis. The DFA comes down somewhere between the two. If the Democrats in Congress who wrote the law had believed that the cause was entirely regulatory failure, they would have revised the regulatory structure, not given yet more power to exactly the same regulators. The fact that they saw expanded regulation as a suitable remedy indicates that they believed the free-market system needed greater control.

My view has always been that the cause was 27 million subprime and other risky mortgages—half of all mortgages in the United States—that were largely a result of the government’s housing policy.¹ When the housing bubble began to deflate, and subprime borrowers could no longer refinance or sell their homes at a higher price, an unprecedented number of defaults began. The resulting losses sank Fannie Mae and Freddie Mac as well as Bear Stearns and Lehman Brothers. The moral hazard engendered by the rescue of Bear led market participants to believe that the U.S. government’s policy was to rescue all large firms. This made a crisis inevitable as soon as any large entity was allowed to fail. Lehman just happened to be that entity. This view, much simpler than the other two, would not have required any additional regulation of the financial system to prevent another financial crisis, only a determination to keep the government from distorting the housing market in the future. But this was not the narrative that drove the adoption of the DFA.

Following the underlying principle that more regulation and less risk taking are the keys to preventing another financial crisis, the act creates a Financial Stability Oversight Council, made up of all the financial regulators and chaired by the secretary of the Treasury. All twenty-six bank holding companies (BHCs) that have assets of more than \$50 billion are made subject to “more stringent” regulation than smaller BHCs, and the council is authorized in its discretion to add an unlimited number of nonbank financial institutions of all kinds to the list of firms that the Fed will be empowered to supervise under the “more stringent” standard. In effect, this will enable the Fed, which already regulates banks and BHCs, to regulate and supervise all the largest nonbank financial institutions in the United States. Since most of these institutions—insurance

companies, securities firms, finance companies, and hedge funds—are not regulated for safety and soundness by any agency at the federal level, there is no reason for the council to object to the Fed’s request for greater regulatory reach.

The unprecedented nature of this authority is important to understand. Not only does the Fed, through the council, have the power to determine the scope of its own authority, but that authority is not limited by the rationale for imposing it. Banks, for example, are regulated for safety and soundness because government insurance for their deposits creates moral hazard—that is, depositors do not care what risks banks are taking because their deposits are insured. (It is not really clear why BHCs are regulated—they are not government-backed—but at least one can say that they have an intimate relationship to the insured banks they control.) Extending the same regulation to firms that are not in any way backed by the government, only because their activities or failure *might* be a

source of instability, is something entirely new. If government regulation and supervision do not create moral hazard directly—and they probably do—they certainly imply that the government has an interest in the activities of these companies that has never before been legally recognized. We are embarking, therefore, on an entirely new path, not a mere extension of what has gone before.

The DFA’s standard for making the important decision about whether to regulate a particular nonbank financial firm is so flexible as to be indistinguishable from complete discretion. The council can designate a firm for this especially stringent regulation “if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”² In effect, this gives the council and ultimately the Fed the power to regulate and supervise any financial institution in the United States if, in the judgment of the council (which effectively means in the judgment of the Fed), the company could under some circumstances yet to be imagined “pose a threat to the financial stability of the United States.”

To put this in context: Bill Isaac, former chairman of the Federal Deposit Insurance Corporation (FDIC), reports in

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his recent book, *Senseless Panic*, that in 1982 he was asked by Fed chairman Paul Volcker to bail out the \$500 million Penn Square Bank (a small strip-mall bank in Oklahoma City) because the bank had sold bad loans to bigger banks and its failure, in Volcker's view, would bring down the whole financial system. The story of Isaac's epic struggle with the weak-kneed Fed consumes seventeen pages in his book.³ Similarly, Richard Breeden, former chairman of the Securities and Exchange Commission (SEC), told a June 2009 AEI conference⁴ about a call he received from the Fed in 1990, when the securities firm Drexel Burnham Lambert, the fourth-largest Wall Street investment bank at the time, was headed for bankruptcy. Again, the caller from the Fed demanded that Breeden agree to bail out the firm, lest the whole market collapse as a result of Drexel Burnham's failure.

Both Isaac and Breeden successfully resisted the Fed's demands, with no adverse consequences for the financial system, but the point is that the first instinct of most regulators, and particularly the Fed, is to fear the worst about disruptions in the economy. Giving the Oversight Council the ability to designate financial institutions as "threat[s] to the financial stability of the United States" because of their "scope, size, scale, concentration, interconnectedness, or mix of [their] activities" is an invitation to subject most of the major financial institutions in the United States to banklike regulation. If the Fed asks—and it will—why would the council ever refuse?

Although it has not received as much attention as other aspects of the DFA, this may be the most troubling provision of this troubling act. To put it plainly, this provision alone has the potential to change the entire nature of our financial system. Once given supervisory power over a financial institution, the Fed can control its capital, liquidity, leverage, and activities, and with this authority can strongly influence the business decisions these firms will make. The focus for these companies will inevitably change from how they can beat their competition to how they can gain the Fed's approval for any new activity. The full-throated, unlimited competition that we are accustomed to in financial services will become a relic of the past. Our aggressive financial industry, which has come to dominate the world, will be tamed—much to the gratification of our trading partners, but not of the American businesses and American consumers who benefited from this competition.

But it gets worse. Can anyone imagine that one of these large financial institutions—securities firms, insurers,

hedge funds, finance companies, and others—that will eventually come under the supervision of the Fed will ever be allowed to fail? A great deal of the debate about the act in Congress focused on the term "too big to fail"—the idea that an institution is so large that it cannot be allowed to

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fail. Congress went to great lengths to close off the opportunities for the FDIC to bail out the large financial institutions that could cause instability in the financial system if they failed. But all of it was probably directed at the wrong agency. Imagine, for example, a large securities firm in the future that is regulated and supervised by the Fed. The securities firm has been mis-

managed, despite Fed supervision (yes, it does happen, see Wachovia), and it is on its way to failure, an event that would of course be embarrassing for the Fed. The Fed, however, because of the DFA, has the power of life and death over all the major BHCs, insurance holding companies, and other large financial institutions. So the Fed chairman calls the chairman of one of these firms and suggests that it would be a good idea if that firm acquired the failing securities firm: "No, we can't offer you any funding, of course, we don't have authority to do that, but there are probably a few other acquisitions you might like to make in the future. . . ."

This is not farfetched. Remember how the Fed and Treasury forced Bank of America to eat Merrill Lynch after its due diligence had revealed the losses involved? Or how the New York Federal Reserve Bank—not even the regulator of many of the financial institutions it called together—arranged for the largest New York financial firm to provide life-saving financing for Long Term Capital Management, a hedge fund that the Fed thought might bring down the financial system if it failed? So all the debate about the FDIC's bailout authority may have failed to consider the Fed's ability to influence the actions of the firms it will be supervising. The real danger is that the Fed will implement "too big to fail" privately, outside public view, through its new powers under the DFA.

Sadly, this is just one example of the DFA's problems. Quietly covering up its own messes is one thing, but many other options are available to a financial supervisor that has so much power. Let's imagine that the largest U.S. banks hold large amounts of another country's debt. If the country fails to meet its obligations, the banks will be seriously weakened, with the possibility of financial instability in the United States. Worse, there could be—at least this is the fear—an international financial crisis.

The Treasury secretary (the chairman of the Oversight Council, incidentally) is quite concerned and calls the Fed chairman, who wants to be cooperative. The solution to the problem, for both the U.S. banks and the international financial system, is to find some buyers for the troubled country's debt. What we need, they agree, are some patient institutional investors with big portfolios, willing to take this country's debt and hold it for a while, bailing out the country and the U.S. banks at the same time—investors, for example, like those insurance holding companies the Fed supervises. At some time in the future, of course, the insurance companies that had to take on this debt will suffer the consequences, but it can later be blamed on imprudent management. An example of exactly this is the blame cast on Fannie Mae and Freddie Mac for buying weak mortgages, when in fact they did so to comply with the government's affordable-housing requirements.

These examples can be multiplied endlessly. What we are talking about here is an incipient partnership between the government and the largest financial institutions in the United States, a partnership in which the big companies are protected against failure but are willing—in fact, eager—to do what the government wants. When we hear the CEOs of large financial firms praising their relationship with the Fed, or the stability that the DFA will bring about, we will know that the partnership idea has taken hold. That is not the financial system we had before the DFA was enacted.

Consumer Protection, Protected from Congressional Control

The DFA also created the Consumer Financial Protection Bureau (CFPB), whose director is also on the Financial Stability Oversight Council, and endowed it with broad regulatory powers. The CFPB probably has the widest reach into the U.S. economy of any agency in Washington. Although some people seem to imagine it is just an independent agency to regulate how banks treat their customers, it has a much broader jurisdiction than that. Below is the list of the business activities over which the CFPB will have jurisdiction, compiled by Davis Polk, a New York-based law firm. For brevity, I deleted the narrow exceptions that were listed as part of the broad activities outlined below:⁵

- Extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit;

- Extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements;
- Engaging in deposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer;
- Providing most real estate settlement services, or performing appraisals of real estate or personal property;
- Providing or issuing stored value or payment instruments, or selling such instruments, but only if the seller exercises substantial control over the terms or conditions of the stored value provided to the consumer;
- Providing check cashing, check collection or check guaranty services;
- Providing payments or other financial data processing products or services to a consumer by any technological means;
- Providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services, including providing consumer credit counseling or services to assist consumers with debt management, debt settlement services, modifying the terms of a loan or avoiding foreclosure;
- Collecting, analyzing, maintaining, or providing consumer reports or other account information, including information related to consumer credit histories, used or expected to be used in connection with any decision regarding the offering or provision of a consumer financial product or service, subject to exceptions; and
- Collecting debt related to any consumer financial product or service.

If we take just one of these services—say, check-cashing—we can begin to understand the scope of this agency's jurisdiction. There are check-cashing stores in virtually every city and town in the United States, and

they are not big businesses. They do not generally operate interstate. If they are subject to regulation, it is by a state or perhaps a municipality. Under the DFA, they will be subject to regulation from Washington. We could assume this regulation will be light, maybe a few reports or an occasional visit by an examiner. But the likelihood is that these small companies will be required to comply with certain rules about disclosure, record keeping, personnel qualifications, hours of operation, advertising, signage, and maybe even their rates and products. What will that do to these thousands of small companies? It will force them to raise their prices, certainly, but also to consolidate with larger companies or leave the business. For those who use check-cashing services, this will make life just a little bit more difficult and expensive. Check-cashing services may require regulation, but state or local regulation is likely to be less intrusive and less bureaucratic than regulation from Washington.

But the worst thing about the CFPB is not the costs it will impose on the economy, the innovation it will stifle, or the small businesses it will eliminate. The worst thing about this agency is that it will operate independently, without any control by the Fed, Congress, or the president. The DFA states that even though the CFPB is lodged in the Fed, it is not subject to the control of the Fed. The autonomy language is clear: the Fed may not

(A) intervene in any matter or proceeding before the Director, including examinations or enforcement actions, unless otherwise specifically provided by law; (B) appoint, direct, or remove any officer or employee of the Bureau; or (C) merge or consolidate the Bureau, or any of the functions or responsibilities of the Bureau, with any division or office of the Board of Governors or the Federal reserve banks. . . . No rule or order of the Bureau shall be subject to approval or review by the Board of Governors. The Board of Governors may not delay or prevent the issuance of any rule or order of the Bureau.⁶

The CFPB is also insulated from control by Congress. Under the U.S. Constitution, Congress exerts control over the executive branch of government through its power to appropriate funds. We all learned about this in grade school as “the power of the purse.” Most regulatory

and administrative agencies, including the cabinet departments, must go to Congress each year for appropriations to cover their operations in the following year. In this way, Congress can control executive-branch agencies by reducing funds, denying fund increases, or denying funds for specific purposes. Merely having to go to Congress

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that in hand for the following year’s appropriation is an important way for Congress to enforce its own policies—and some humility—on powerful agencies. The CFPB, however, is exempt from this process. Under the DFA, it is allocated up to 12 percent of the Fed’s operating funds, a stipend that amounts to an estimated \$600 million per year. The Fed’s operating funds are not subject to appropriation—

part of the special structure intended to keep the central bank independent of the political branches—so the \$600 million that will be made available to the CFPB does not come with any necessary oversight or control, directly or indirectly, by Congress. The only way Congress will be able to control this agency is through amending its governing law.

Finally, the CFPB will be independent of the president, since the director is appointed for a five-year term by the president, with the advice and consent of the Senate, and can only be removed from office for cause.

The CFPB, then, is as independent as the Fed itself, but it has the power to control and regulate the consumer-related operations of companies from the largest banks to the smallest check-cashing stores. Moreover, all this power is concentrated in a single person, the director of the CFPB. Even the Fed, with all its independence, is ultimately governed by a board with a bipartisan membership. The establishment of an agency with this scope of authority, under the direction of a single person removable only for cause, outside the control of Congress or the president, is an unprecedented and—I might say—an irresponsible act, which Congress will eventually come to regret.

Stability as the Goal

The structure and substantive elements of the DFA—and indeed all legislation—arise out of a combination of perceptions and ideology. The perceptions that guided the development of the DFA were that deregulation and a lack of regulation were largely responsible for the financial crisis. The underlying ideological notion, which both fed that perception and was driven by it, was that the

unregulated market—because of risk taking—will always create financial crises of this kind. Of course, if we ignore the government’s role in creating the crisis, outlined above, our search for causes necessarily narrows to the deficiencies of the market.

True, free markets take risks; it is in their nature. Risk taking in turn produces failure, disruption, and losses; it is supposed to, since the failures caused by risk taking or incompetence take society’s assets out of the hands of bad managers and put them in the hands of good ones. Innovation involves risk, as does entering new markets, cutting prices, investing for growth, and everything else that has brought material progress in the two centuries since the advent of the Industrial Revolution. As Raghuram G. Rajan observed in his recent book, *Fault Lines*, “We have to recognize that the only truly safe financial system is a system that does not take risks, that does not finance innovation or growth, that does not help draw people out of poverty, and that gives consumers little choice. . . . In the long run, though, that reinforces the incremental and thus the status quo.”⁷

The drafters of the DFA feared risk taking, innovation, and change, and the act shows it. The best examples are the Volcker rule and the draconian restrictions that the Fed can impose on large nonbank financial institutions that are considered important because they might, under some circumstances, create instability in the U.S. financial system if they fail. Adopted with fear of instability in mind, all of these new restrictions will make it difficult for competition and risk taking to break out among banks, BHCs, and the large nonbank financial firms that will fall under the Fed’s regulatory umbrella.

The Volcker rule prohibits any “banking entity”—which includes a bank, its BHC, and all subsidiaries of the bank and the BHC—from engaging in proprietary trading. Prop trading is the business of trading securities, loans, derivatives, or any other asset for the account of the banking entity itself and not as a service for customers. The fact that the restriction applies to the BHC and all BHC subsidiaries shows the extreme risk-aversion that animated this provision. First, there is no indication that prop trading had anything to do with the financial crisis; in fact,

it is one of the activities that added significantly to the much-needed revenues and profits of the beleaguered banking system during the past few years. Second, because the BHC and the BHC’s subsidiaries do not take deposits and have only very limited access to loans or other financing from the bank itself, a case cannot be made that the depositors’ funds or the government’s deposit insurance was being used to take substantial risks.

Nevertheless, these restrictions will take out of the financial markets a substantial number of participants that had added valuable liquidity. Without banks, BHCs, and their affiliates, vigorous trading that keeps spreads narrow and liquidity high in the U.S. market will substantially decrease. The likelihood is that foreign banks will become the dominant players in the business and world financial markets will move away from the United States.

This also raises a significant question about the future of the banking business. The development of an efficient securities market in the 1960s changed the relationship between banks and their corporate clients. Companies that had registered securities with the SEC found it less expensive and burdensome to meet their credit needs in the securities markets than through bank borrowing. As a result, banks have been concentrating increasingly on trading activities, private banking for

high-net-worth individuals, small-business lending, consumer lending through credit cards, and commercial and residential real estate finance. The largest of these activities is real estate lending, through construction and development loans and commercial and residential mortgages.

This is not a healthy development. As noted in the November–December *Financial Services Outlook*,⁸ bank lending to real estate in all its forms rose from less than 25 percent of all bank lending in 1965 to more than 55 percent in 2005. Real estate is a risky and highly volatile business, and banks are already too heavily involved in it. By taking away another profitable non-real-estate business from banks, the DFA forces them to concentrate even more heavily in real estate financing. This makes it more likely that the deflation of the next real estate bubble will create another banking crisis.

The Volcker rule applies to all banks and BHCs, but the restrictions on large BHCs and nonbank financial

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institutions could extend much further than restrictions on prop trading. In this case, as noted above, the Oversight Council may authorize the Fed—the supervisor of those large financial institutions and BHCs that have been declared a potential danger to U.S. “stability”—to impose “regulations that are more stringent than those applicable to other nonbank financial companies and BHCs that do not present similar risks to the financial stability of the United States.”

The purpose of these more stringent regulations is to “prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions.”⁹ By classifying “ongoing activities” as a potential threat to stability, the act creates a license to curb and discipline the aggressive firms that might upset the stable, politely competitive environment that the act envisions for the future of the financial industry.

Efforts to curb bank activities because they are insured by the FDIC have been part of the political debate in Washington since deposit insurance was instituted. Most of the opposition to new or existing bank activities has grown out of competition between industries. For example, the realtors have fought the idea that banks or BHCs should be allowed to own real estate brokers. But the DFA is the first example since the passage of the Glass-Steagall Act in which restrictions on bank and BHC activities have been imposed solely because of the fear of risk taking. In this sense, the Volcker rule may be the vanguard of further restrictions on bank activities and bank size.

One way out of this thicket was the solution in the Gramm-Leach-Bliley Act: to allow banks themselves to grow smaller voluntarily by shifting some of their capital to their holding companies, where more risky activities could be undertaken without risk to the deposit insurance fund. But by cutting off prop trading even at the holding-company level, the Volcker rule creates a precedent for BHCs to be as limited in their activities as banks. The irony is that the DFA also requires BHCs to be sources of strength for their subsidiary banks. How they are supposed to do that when their activities are restricted largely to what banks can do is not clear.

Acting out of the fear of change and “instability,” those who voted for the DFA—mostly Democrats but also a few

Republicans—have given the government extraordinary regulatory power, which it can use to prevent change, innovation, and economic growth. It is another sign that the modern proponents of corporatism—a partnership between big government and big financial institutions—won the day in the U.S. Congress, and that what they have done will be hard to undo in the future. Advocates of Joseph Schumpeter’s “creative destruction,” in which new and innovative companies displace old ones, had better look outside the United States for innovation and change in the financial markets—and they will.

Notes

1. See, for example, Peter J. Wallison, “Ideas Have Consequences: The Importance of a Narrative,” *AEI Financial Services Outlook* (May 2010), available at www.aei.org/outlook/100960.

2. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010), §113(a)(1).

3. William M. Isaac and Philip C. Meyer, *Senseless Panic: How Washington Failed America* (Hoboken, NJ: John Wiley & Sons, 2010), 29–46.

4. Richard Breeden, “Addressing Systemic Risk” (conference, AEI, Washington, DC, June 3, 2009), available at www.aei.org/event/100061.

5. Davis Polk, “Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010,” 104–105, available at https://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (accessed August 24, 2010).

6. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, §1012(c)(2)–(3).

7. Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton, NJ: Princeton University Press, 2010), 19.

8. Peter J. Wallison, “Losing Ground: Gramm-Leach-Bliley and the Future of Banking,” *AEI Financial Services Outlook* (November–December 2009), 4, available at www.aei.org/outlook/100925.

9. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, §115.